No. 78-1173

In the Supreme Court of the United States

October Term, 1978

Maclin P. Davis, Jr., et al., petitioners

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented in this federal income tax case is whether the purported transfer of residential apartment complexes by three corporations to their stockholders was sufficient to shift the income and deductions attributable to that realty to petitioners, who are the shareholders of the corporations.

The pertinent facts are as follows: Petitioners are stockholders in three corporations, which were formed to obtain financing, construct, and manage apartment projects pursuant to programs established by the Department of Housing and Urban Development to provide housing for low and moderate-income families (Pet. App. B-2).[1]

[1] See National Housing Act, Section 221(d)(3), 12 U.S.C. 1715*l*(d)(3).

All three corporations obtained loans to finance 100 percent of the construction costs from private mortgage companies, with the Federal Housing Administration (FHA) acting as guarantor of the loans (I-R. A51-A53). Each corporation entered into a "regulatory agreement" with the FHA, which provided that the approval of the Federal Housing Commissioner would be required for the adoption of rental schedules; the conveyance, transfer, or encumbrance of the property of the project; and any contract for supervisory or managerial services (see, *e.g.*, Joint Ex. 9-I; I-R. A143).[2]

The corporate form of ownership prevented the shareholders from claiming the benefits of the net tax losses generated by the property. Accordingly, after the completion of construction, the corporations entered into an agreement with the stockholders purporting to transfer their interest in the apartment property to the stockholders, as tenants in common, in proportion to their respective shareholdings. The pertinent portions of the agreements (all of which were substantially the same) provided that the transfers were to be made by deed, that the corporations would continue to be liable on the mortgage notes, that the corporations would remain fully responsible to the FHA for the regulatory agreements, and that each corporation would continue to possess and manage and maintain its respective apartment complex (I-R. A151-A152, A171-A172; II-R. A192-A193). Quitclaim deeds from the corporations to the shareholders were executed, but were not recorded (III-R. A369, A374, A538). Although the Federal Housing Commissioner was advised of the execution of the deeds (II-R. A358, A360; III-R. A362), the corporations never received the approval required by the regulatory agreements (Pet. App. B-5).

[2]"R." refers to the three-volume record filed in the court of appeals.

On their tax returns filed for the year in question, each corporation reported as income the gross rents received from its respective apartment project, and claimed deductions for most of the operating expenses (III-R. A509-A514; IV-R. A703). The deductions claimed included amounts characterized as "Management Fees" (II-R. A321), "Fees paid to tenants in common" (II-R. A311), or "Rental on Apartment Property" (II-R. A294) which actually represented payments of interest and principal made on the mortgage loans (see II-R. A208).

Those "fees" were in turn reported as "income from rents" on partnership returns filed by petitioners.[3] From that "income," the partnerships deducted the interest portion of the mortgage payments, depreciation, and incidental expenses. In each case, the deductions claimed exceeded the income, resulting in a net loss to the partnership which was then allocated among the partners (II-R. A208; IV-R. A700, A701).

On audit, the Commissioner of Internal Revenue disallowed petitioners' claimed deductions for their pro rata shares of the 1969 losses attributable to the three apartment properties on the ground that the transfer of title from the corporations to petitioners were sham transactions (I-R. A16, A19, A22, A33, A37) so that the beneficial ownership of property remained in the hands of the corporations. The Tax Court upheld the Commissioner's determination (Pet. App. A-1 to A-13) and the court of appeals affirmed (Pet. App. B-1 to B-18).

1. The decision below correctly held that the income and deductions attributable to the apartment properties had to be reported by the corporations and not by

[3]Partnership returns were filed for Hillside Apartments Company, a partnership composed of the shareholders of Harpeth, Inc.; Bedford Apartments Company, composed of the shareholders of Bedford Manor, Inc.; and Urban Apartments Company, composed of the shareholders of Urban Manors East, Inc. (IV-R. A699, A700, A701-A702).

petitioners. As the court of appeals pointed out (Pet. App. B-9), the transfers of title from the corporations were not the result of arms-length negotiations between independent parties. Simply put, the corporations would not have entered into those agreements had they not been controlled by petitioners to whom the transfers were made. There were no visible, appreciable benefits to the corporations. Petitioners gave no consideration for transfers, and the corporations were not relieved of the burdens of ownership of the apartment properties.

Moreover, the transfers of title made no significant change in the economic relationships of the parties involved. Most of the attributes of the ownership of the apartment property remained with the corporations under the terms of the transfer agreements. The deeds were not recorded, so that record title remained in the corporations. Each corporation continued to possess the property and was solely responsible for all maintenance and repairs at its own expense. The corporations alone were liable on the mortgage notes. The stockholders did not assume any part of the corporations' responsibility to the FHA under the regulatory agreements. Indeed, the transfer agreements expressly provided that the corporations' obligations were to continue exactly as if no transfers had been made. And, finally, there were no substantial business reasons, other than tax avoidance, for these transactions. As the Tax Court found (Pet. App. A-7), the sole purpose of the nominal title transfers was to enable the stockholders to use the interest and depreciation deductions generated by the projects to shelter other individual income.[4]

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[4]Petitioners argue (Pet. 8) that Congress intended to provide exactly the tax shelter benefits sought here. As the court of appeals noted (Pet. App. B-9 n.7), however, the legislative intent was to provide tax benefits to the true owners of low income rental housing, not to validate transfers of title that have no economic substance.

2. Contrary to petitioners' contention (Pet. 6-8), the decision below does not conflict with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). There, the Court held that an arrangement under which a bank constructed a new office building and sold it to the taxpayer, who in turn leased it back to the bank, was not a sham, and was sufficient to shift the incidents of ownership of the property to the taxpayer who could thereby report the income and deductions attributable to the property. In so concluding, the Court found persuasive facts that the transaction placed the risks normally associated with building ownership upon the taxpayer, because it was taxpayer alone who was liable on the mortgage note and who bore the risks of building depreciation (*id.* at 577, 581); that the entire sale and leaseback arrangement and the terms of the various agreements were the result of extensive bargaining between independent parties (*id.* at 582); that there was substantial economic motivation apart from tax considerations for the structure of the transaction because the bank had been denied permission by the Federal Reserve System to construct the building using more conventional methods of financing, and that one of the taxpayer's principal reasons for entering the transaction was its desire to diversify (*ibid.*). Since none of these factors is present in the instant case, *Frank Lyon Co.* is distinguishable.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

MARCH 1979